

Decision **PROPOSED DECISION OF ALJ DUDA** (Mailed 10/12/2012)

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

In the Matter of Application of Kerman Telephone Co. (U1012C) d/b/a Sebastian, to Review Intrastate Rates and Charges and Rate of Return for Telephone Service Furnished within the State of California, and to Modify Selected Rates.

Application 11-12-011  
(Filed December 28, 2011)

**DECISION DENYING JOINT MOTION FOR ADOPTION  
OF ALL-PARTY SETTLEMENT AGREEMENT**

**1. Summary**

Kerman Telephone Co. d/b/a Sebastian (Kerman) filed an application for a general rate case (GRC) which included a requested test year draw from the California High Cost Fund-A (CHCF-A) in excess of its historic and current draw, while maintaining rates for all customers at current levels. Following a protest from the Commission's Division of Ratepayer Advocates (DRA) and two prehearing conferences, Kerman and DRA entered into an "all-party" settlement agreement as to all elements of the GRC, including an increase in the CHCF-A draw, albeit less than initially requested by Kerman. Given the totality of circumstances, including the current review of the CHCF-A, the all-party settlement is found to not meet all of the requirements for approval, specifically not being reasonable in light of the whole record nor being in the public interest. Therefore, the Joint Motion for Adoption of All-Party Settlement Agreement is

denied. Modifications to the settlement are suggested that, if made, would allow requisite findings to be made for approval of a settlement.

## **2. Background**

Kerman Telephone Company d/b/a Sebastian (Kerman) is a small local exchange carrier (LEC) subject to rate of return regulation and serving customers in the vicinity of the City of Kerman in rural Fresno County. The California High Cost Fund-A (CHCF-A) is a statutorily established public purpose program, the purpose of which is to assist small independent telephone corporations serving rural and small metropolitan areas. (Pub. Util. Code. § 275, 275.6, 739.3.<sup>1</sup>) As set by statute:

The Commission shall develop, implement, and maintain a suitable program to establish a fair and equitable local rate structure aided by universal service rate support to small independent telephone corporations servicing rural and small metropolitan areas. The purpose of the program shall be to promote the goals of universal telephone service and to reduce any disparity in the rates charged by those companies. (§ 739.3(a).)

The CHCF-A is funded by a surcharge on the end-user California intrastate jurisdictional revenues (other than Lifeline) of all telecommunications carriers under the Commission's jurisdiction including, for this purpose, all interconnected Voice over Internet Protocol (VoIP) providers. (See Pub. Util. Code § 285.) It was most recently set by Resolution T-17357, effective July 1, 2012 at 0.40%.

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<sup>1</sup> All statutory references are to the California Public Utilities Code.

In order to withdraw funds from the CHCF-A, a small LEC is required to file a general rate case (GRC). If, after a GRC review, the Commission determines that revenue from customers is insufficient to maintain rates no higher than 150% of the rates for comparable services in urban areas, the CHCF-A subsidy is utilized to cover the shortfall. A small LEC's CHCF-A subsidy is then subjected to a "waterfall" by which the subsidy is phased down over a six-year period. It is maintained at 100% of the authorized amount for three years, 80% the fourth year, 50% the fifth year and then 0%.<sup>2</sup>

Kerman's last general rate case was filed in 2006.<sup>3</sup> Kerman subsequently went through the "waterfall" process noted above. Absent this application, Kerman's draw from the CHCF-A will drop to 0%.

In November 2011, the Commission initiated Rulemaking (R.) 11-11-007 (CHCF-A Rulemaking) with the express purpose of undertaking a comprehensive review of the purposes, operations and benefits of the CHCF-A. Specifically the Commission stated:

A detailed review of the program is warranted in response to market, regulatory, and technological changes since the California High Cost Fund program was first established in 1987. In this OIR, we seek comment on how the program can more efficiently and effectively meet its stated goals. To the extent deficiencies are identified, we solicit constructive proposals on whether the program should continue and if so, how should it be modified. (R.11-11-007 at 2.)

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<sup>2</sup> Decision (D.) 88-07-022, Appendix B, Part D discusses the phase down. The "waterfall" process was formalized in D.91-05-016 and finalized in D.91-09-042 in the Appendix, Implementation Rules, Section D.

<sup>3</sup> Resolution T-17081, November 1, 2007.

The CHCF-A Rulemaking noted the many technological changes in the telecommunications industry, such as the decline in predominately landline telephones when the CHCF-A was adopted to the current prevalence of wireless communications and growth of internet based VoIP services. Significant regulatory changes, produced by these technology changes and competitive forces, have also occurred, e.g., the deregulation of incumbent local exchange carrier rates for all carriers other than the small LECs. (R.11-11-007 at 2-3.)

The Commission's Division of Ratepayer Advocates (DRA) protested Kerman's application asking that it be stayed until R.11-11-007 is concluded and recommending that Kerman be authorized to continue its CHCF-A fund draw at the current waterfall level. DRA stated that if the GRC were to go forward, DRA would raise a number of issues relating to facility upgrades, return on equity, local service rates and charges, CHCF-A draw, plant additions and depreciation. (Protest of DRA at 2-3.)

Kerman challenged DRA's request for a stay on procedural grounds, contending a hearing and Commission decision was required to stay a rate case for a small LEC since the schedule for such proceedings is set forth in a Commission decision.

A prehearing conference (PHC) was conducted by the assigned Administrative Law Judge (ALJ) on March 20, 2012. Workload and timing challenges for processing the application were discussed, as well as the pendency of the CHCF-A Rulemaking. The ALJ urged Kerman and DRA to engage in settlement discussions. To the extent DRA's protest was a request to stay the proceeding, the ALJ denied that request as procedurally inappropriate. (PHC 1 Tr. 5.)

A second PHC was held on May 30, 2012, for the purpose of checking the progress of settlement discussions and establishing a schedule for the proceeding in the event a settlement was not reached. Kerman and DRA held settlement discussions and on May 29, 2012, held a noticed, all-party settlement conference pursuant to Rule 12.1(b) of the Commission's Rules of Practice and Procedure (Rule or Rules). On June 29, 2012, Kerman and DRA filed a Joint Motion for Adoption of All-Party Settlement Agreement (Joint Motion) to which the Settlement Agreement was attached as Exhibit 1.

### **3. The Application Request**

Kerman's application had the following primary elements:

- \$5.8 million in network upgrades and use of CHCF-A fund for these investments;
- Return on Equity of 14.81%; Return on Rate Base of 12.69%;
- Proposed changes to local service rates and charges;
- CHCF-A support of \$6.49 million;
- \$2.9 million in plant additions; and
- Proposed depreciation expense for test year 2013.

The current return authorized for Kerman is 10.0% on rate base. Kerman's current draw from the CHCF-A is \$3,443,036 and their request would thus be 88% higher than its recorded draw for 2011 and expected draw for 2012.

While Kerman proposed to retain basic residential rates at current levels, other service charges were proposed to increase. For example, Kerman proposed increases to inside wire, repair, visit and returned check charges of 100% or more. (Application at 2-3.) Kerman states in its application that even with these changes, its estimated customer revenue will decrease by approximately \$90,000. (*Id.* at 3.)

**4. The DRA Protest**

As noted above, DRA protested the application based on considerations of both workload constraints and the pending CHCF-A Rulemaking. DRA did not have specific alternative recommendations as to revenue requirement, rates of return, customer rates or CHCF-A draw as part of its protest. Its principal recommendation was to maintain the status quo in terms of draw, relying on what is referred to as the “waterfall provision.” As noted previously, under the CHCF-A waterfall provision, in years subsequent to a general rate case in which a CHCF-A draw is authorized, the CHCF-A draw diminishes over time in specific steps. In order to maintain a CHCF-A draw beyond the time at which the waterfall steps would eliminate the draw, the small LEC needs to file a new general rate case application as Kerman did here. DRA proposed that Kerman be allowed to maintain the prior year’s CHCF-A draw – essentially an additional waterfall year – pending the conclusion of the CHCF-A Rulemaking.

**5. The Prehearing Conferences**

As noted above, a PHC was conducted by the assigned ALJ on March 20, 2012. At the PHC, the ALJ indicated that this was an unusual situation in that the Commission had an open rulemaking looking at potentially modifying the CHCF-A in ways that could impact Kerman. She noted this as a good reason to not proceed with the GRC. She identified as a threshold question whether the GRC should go forward under these circumstances and noted that a threshold question in the scope of the case was whether the Commission should freeze Kerman’s revenue requirement at its current draw. (PHC 1 Tr. 14.)

Given both considerations, the ALJ urged Kerman and DRA (the only parties to the application) to consider the potential for a settlement and indicated

that the Commission could provide assistance through its alternative dispute resolution process.

A second PHC was held on May 30, 2012 for the purpose of checking the progress on settlement discussions and establishing a schedule for the proceeding in the event a settlement was not reached. The ALJ stated that if the application were to go forward she saw two threshold issues: (1) whether to freeze Kerman's revenue requirement and CHCF-A draw at the current levels until the Commission concludes or reaches a decision in R.11-11-007; (2) if the draw is frozen, when Kerman would be eligible to file a general rate case. (PHC 2 Tr. 35.) The ALJ proposed to take comment on the threshold issues and then present a proposed decision to the Commission to determine if a freeze should be imposed. If rejected, the rate case would resume, considering the substantive issues previously identified. The ALJ noted it was premature to set a schedule for testimony and hearings on Kerman's GRC request as they might not be needed. (PHC 2 Tr. 36.)

## **6. The Proposed Settlement**

As noted above, Kerman and DRA engaged in settlement discussions resulting in the Settlement attached to the Joint Motion.

The primary elements of the Settlement are as follows:

- Cost of capital – overall 10% rate of return, with no specified capital structure;
- Operating revenues – local network service revenues forecasted (at local end user rates (unchanged from present) and charges) as \$2,057,195 for test year 2013, an increase of \$69,085 from Kerman's application request;
- Depreciation expenses - \$2,790,844;

- Other operating expenses (other than depreciation) - \$7, 902,125, a reduction of \$911,654 from the application request;
- Rate base – Total forecasted plant additions are \$2,900,000 for 2012 and \$875,740 for 2013, for a total of \$3,775,740, a reduction of \$2,024,260 from the aggregate 2012/2013 request; and CHCF-A draw - \$4,274,774, an increase of \$831,738 from the current draw; a decrease of \$2,215,689 from the application request.

## **7. Does the Proposed Settlement Meet the Standards for an All-Party Settlement?**

The Commission has established a three-prong test for consideration of settlements: 1) whether the settlement is reasonable in light of the record; 2) consistent with the law; and 3) in the public interest. (*See* Rule 12.1(d).) To be approved a settlement must meet all three requirements.

## **8. Is the Settlement Reasonable in Light of the Record?**

The record in this proceeding consists of the application, the protest of DRA, the settlement, and various representations at the two PHCs. While testimony in support of the application was served by Applicant, it has not been identified or received. DRA did not prepare or serve testimony, but its protest includes a request that the matter either be stayed or the CHCF-A draw be maintained at the existing level, pending the outcome of R.11-11-007. We can also take official notice of our existing rulemaking regarding CHCF-A, R.11-11-007 and pending motions in that proceeding.<sup>4</sup>

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<sup>4</sup> See October 15, 2012 pending motion of Independent Small ILECs requesting a one year stay in the small ILECs' rate case cycles and associated water fall mechanism, and

*Footnote continued on next page*



The settlement presented provides for a total rate of return of 10% (without a specified capital structure). This is the same rate of return authorized for Kerman in 2007 as well as for other recent small LECs.

The settlement holds all customer rates and charges unchanged.

Most significantly, the settlement includes an increase of nearly 25% (24.16%) from its current CHCF-A draw.

Given the pending CHCF-A Rulemaking and outstanding motions in that docket to freeze CHCF-A draws at existing levels and stay rate case applications until December 2013, we find it premature to allow an increase in the CHCF-A draw for Kerman at this time. The ALJ conveyed at the PHCs that the threshold issues in this proceeding were whether anything other than maintenance of the status quo was appropriate given the pending CHCF-A Rulemaking and when would it be appropriate for Kerman to make a future GRC filing if its CHCF-A draw was frozen at this time. This direction should have served to advise the settling parties that they would bear a burden to demonstrate that any increase in the CHCF-A draw was reasonable under the circumstances.

The settlement presented does not reflect sensitivity to these concerns. While the settlement notes it is a significant reduction from Kerman's initial request for an 88% increase in its CHCF-A draw, it still represents an almost \$1 million increase in Kerman's CHCF-A subsidy.

In general, we are concerned that this settlement would grant an increase in CHCF-A subsidy to one company while motions are pending to freeze

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January 18, 2012 pending motion of DRA to freeze the waterfall provisions of the CHCF-A and suspend A-fund companies rate case applications.

subsidies to all other carriers. The ALJ emphasized at the two PHCs that the threshold issues in the case were whether to freeze current CHCF-A subsidies pending review of the CHCF-A in R.11-11-007, and the appropriate timing for Kerman to make a future GRC filing. If the primary purpose of the settlement is to avoid contentious and lengthy rate case proceedings due to resource constraints and other more urgent business, a freeze or an effort to maintain the status quo is more appropriate. Although the ALJ stressed this in her discussions with the parties, the parties settled the matter on a significantly different basis. In hindsight, the ALJ perhaps should not have granted the parties any settlement opportunity and should have proceeded directly to the threshold issues of a freeze to maintain the status quo and timing of any future GRC. The ALJ may have thought that her guidance to settle was understood to mean a settlement involving a freeze and how long it would apply. While it is unfortunate that this direction was taken as a suggestion rather than the direction intended, it is not necessary for us to approve this settlement if we do not find it in the public interest.

### **9. Is the Settlement Consistent With Applicable Law?**

There is nothing seemingly inconsistent with any specific provision of law. The application was filed in a timely fashion under adopted rate case plan provisions. There is nothing specific to indicate that the requested expense, CHCF-A draw or other terms and provisions violates any provision of law, Commission decision, general order or other requirement. The one element noted by the settling parties is whether Kerman would have the opportunity to earn a reasonable rate of return. Since Kerman has entered into the settlement, the Commission may assume that Kerman is satisfied this element is met.

**10. Is the Settlement In the Public Interest?**

The CHCF-A surcharge is assessed against the California jurisdictional revenues of all interconnected telecommunications providers. It is a surcharge established to promote the goals of universal service in high cost rural areas. While the goals are appropriate and unchallenged, due to both changes in the industry and concerns about how the funds are utilized, there have been concerns as to how well the program is meeting its goals and whether it is doing so in a cost-effective manner.

For that reason, R.11-11-007 was initiated so that we could review all aspects of the program – including fairness and effectiveness.

With all of this background, the application as filed sought a significant increase in Kerman's CHCF-A draw. Although the settlement reduces the increase, it would still result in an increase of almost \$1 million in CHCF-A subsidy.

Given the Commission's expressed concerns and current scrutiny of the CHCF-A program, the settlement is not in the public interest because it is inappropriate to increase the CHCF-A subsidy to one carrier, absent close scrutiny of the need for the request. The Commission is considering CHCF-A changes, and possible reductions, to all participating carriers and is considering pending motions in R.11-11-007 to freeze subsidies to small LECs such as Kerman at current levels for one year. Indeed Kerman joined in the motion of the Independent Small ILECs to request a freeze until December 2013.<sup>5</sup>

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<sup>5</sup> See October 15, 2012 Motion of Independent Small LECs in R.11-11-007.

**11. Effect of Rejection of Settlement**

The Commission acknowledges Kerman's expectations flowing from its decision to timely file an application for a general rate case. We also appreciate the current workload burdens placed upon all segments of Commission employees, including DRA. Nonetheless, given our clear concerns about the scope and direction of the CHCF-A, we are not prepared to treat this application as though R.11-11-007 did not exist. We urge the parties to renegotiate a settlement that comports with the directions given in this decision. If parties do not settle within 20 days of this decision, the ALJ should proceed to address the threshold issue, as stated in the scoping memo, of a freeze in the CHCF-A draw at the current level coupled with when a subsequent general rate case could be considered.

**12. Comments on Proposed Decision**

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed by Kerman and DRA and reply comments were filed by DRA.

Kerman comments that the proposed decision will have a chilling effect on settlements and alternative dispute resolution since it rejects a settlement after parties were explicitly directed to fashion one. Kerman maintains the settlement is reasonable and to reject it would unlawfully deprive Kerman an opportunity to earn its authorized rate of return. Kerman also contends the proposed decision is arbitrary and capricious because it rejects a settlement purely because of a pending rulemaking. Kerman further contends the proposed decision

would have a negative impact on DRA's role in settlement discussions, as parties will be less willing to settle with DRA.

DRA comments that it believes the settlement meets the requirements of being reasonable and in the public interest. DRA disagrees with Kerman's allegation that rejection of the settlement will negatively impact DRA's effectiveness, particularly in settlements. DRA maintains that the Commission's use of its broad authority to adopt or reject a settlement will not impair DRA's statutory role as a consumer advocate.

We do not agree with Kerman that rejection of this settlement has a chilling effect on future settlements or is arbitrary and capricious under the circumstances in this matter. Under the unique circumstances of this application and the pending CHCF-A rulemaking, it is not in the public interest to give an almost \$1 million increase to one carrier absent greater scrutiny of the need for the request. No other carriers have received an increase in rates since the Commission opened the CHCF-A rulemaking specifically to examine subsidy levels. Indeed, Kerman has joined other carriers in supporting a freeze of subsidy levels while the rulemaking is considered. Further, the ALJ in this matter did not need to give the parties time to settle and could have proceeded straight to the threshold issue of freezing Kerman at its current subsidy level. In hindsight, this might have been a wiser choice. Nevertheless, it is reasonable to reject the settlement which would increase CHCF-A subsidies while the program is under review. We agree with DRA that rejection of this one settlement has no impact on DRA's consumer advocacy role.

### **13. Assignment of Proceeding**

Michel Peter Florio is the assigned Commissioner and Dorothy J. Duda is the assigned ALJ in this proceeding.

### **Findings of Fact**

1. Kerman is a small LEC that currently draws \$3,443,036 from the CHCF-A.
2. The CHCF-A subsidy is subject to a waterfall by which the subsidy is phased down over a six-year period.
3. In November 2011, the Commission opened R.11-11-007 (the CHCF-A Rulemaking) to undertake a comprehensive review of the purposes, operations and benefits of the CHCF-A given concerns whether the program is meeting its goals cost-effectively.
4. DRA protested this GRC application by Kerman for a revenue requirement increase, and recommended Kerman continue to draw from the CHCF-A at its current waterfall level until the conclusion of the CHCF-A Rulemaking.
5. Kerman and DRA filed a Joint Motion for Adoption of All-Party Settlement Agreement on June 29, 2012.
6. The Kerman and DRA Settlement includes a 10% rate of return for Kerman and a CHCF-A draw of \$4,274,774, which is a 24% increase over its current draw.
7. Pursuant to Rule 12.1(d), the Commission will not approve a settlement unless it is reasonable in light of the whole record, consistent with law, and in the public interest.

### **Conclusions of Law**

1. It is difficult to evaluate whether the Settlement's proposed 10% rate of return is reasonable given that no capital structure is indicated in the Settlement.
2. Kerman and DRA bear the burden to demonstrate that any increase in the CHCF-A draw is reasonable in light of the whole record and in the public interest.
3. A freeze of Kerman's CHCF-A current draw would maintain the status quo until the Commission concludes its review of the CHCF-A.

4. It is not reasonable to increase Kerman's CHCF-A draw by close to \$1 million, absent closer scrutiny, when the Commission is considering CHCF-A changes, and possible reductions in subsidies.

**O R D E R**

**IT IS ORDERED** that:

1. The Joint Motion for Adoption of All-Party Settlement Agreement filed by Kerman Telephone Company d/b/a Sebastian and the Division of Ratepayer Advocates on June 29, 2012 is rejected.

2. Unless Kerman Telephone Company d/b/a Sebastian and the Division of Ratepayer Advocates reach a new settlement agreement within 20 days of the effective date of this decision, the Administrative Law Judge assigned to this proceeding shall proceed to address the issues outlined in the scoping memo of this case.

This order is effective today.

Dated \_\_\_\_\_, at San Francisco, California.